

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

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POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

RESPONSES OF UNITED STATES POSTAL SERVICE WITNESS STRASSER
TO QUESTIONS POSED DURING ORAL CROSS-EXAMINATION

The United States Postal Service hereby provides the responses of witness Strasser to questions raised during cross-examination on August 31, 2000. These responses are being provided later than requested due to the delay in receipt of the transcript volume for these hearings, which did not occur until late on September 8. Due to the current unavailability of the witness, a signed declaration will be provided subsequently.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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September 12, 2000

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS STRASSER
TO QUESTIONS POSED DURING ORAL CROSS-EXAMINATION

Tr. 46A/20229

Counsel for the Direct Marketing Association requested the amount of revenue from real estate that is in the Postal Service's FY 2000 operating plan.

RESPONSE:

\$50 million.

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS STRASSER
TO QUESTIONS POSED DURING ORAL CROSS-EXAMINATION

Tr. 46A/2-282

Counsel for the Office of the Consumer Advocate asked for the source of the CPI-W and ECI figures used in Table 1 on page 16 of USPS-RT-1.

RESPONSE:

The source of these figures is DRI USSIM/Control 0500 (May 2000) fiscal year annual indices.

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS STRASSER
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Tr. 46A/20331-32, 20340

Counsel for ValPak and Carol Wright and Commissioner Goldway asked about the effect of rate increase on derivation of EVA (economic value added) and counsel requested a Postal Service publication explaining the program.

RESPONSE:

As I testified, rate increases are indexed out of the EVA calculation so that calculation only reflects "real" increases. A copy of Handbook F-6A , Chapter 2, "The National Indexed EVA Calculation," is attached. In Exhibit 2-2.1, in the row labelled "- Rate Change Adjustment" a deduction from EVA of \$74.079 million is noted for FY 1998. This is the full year impact of the special services case, Docket No. MC96-3 rate increases that went into effect in AP 10 of FY 1997. For FY 1999 a deduction of \$1,225.706 million is noted. This is a combination of the full year impact Docket No. MC96-3 and the partial year impact of the Docket No. R97-1 rate increases implemented during AP 5 of FY 1999. The \$1,225.706 million is the sum of \$74.079 million from MC96-3 and \$1,181.627 million from R97-1. When final FY 2000 EVA is calculated it will include the full year impact of R97-1 as well as the full year impact of MC96-3. As indicated by these calculations, the rate increase deductions are cumulative off of a FY 1997 base.

2 The National Indexed EVA Calculation

The national indexed EVA calculation has an accounting framework of accounts. Elements of national indexed EVA are year-to-date (YTD) calculations of revenue, expenses, net operating income (NOI), and capital charge. Computing each of these national elements is discussed below. Indexed EVA funds the incentive funding pool. Potential credit and potential payout incentives are calculated off the funding pool.

2-1 Terms and Definitions

Accounts — Capital accounts mentioned in some exhibits are found in the Auditor Balance Sheet. Expense accounts can be found in the National Consolidated Trial Balance (NCTB). Total expenses and revenue lines can be found in the National Consolidated Revenue and Expense Report (NCR&ER).

Capital — All resources used in generating net operating income. Accordingly, to calculate an EVA capital charge, adjustments are needed to determine the amount of capital invested in the Postal Service. The elements of capital are fixed assets, the present value (PV) of operating leases, networking assets, and other noncurrent assets.

Capital charge — Charge for the capital resources invested in the business (i.e., cost of capital times the average capital balance).

Cost of capital — Expected return from resources invested or employed in the business. A percentage representing a blended cost of debt and equity. Since FY 1996, the Postal Service has used a 12 percent cost of capital, comparable to private-sector competitors.

Economic adjustments — Adjustments for nonoperating, nonrecurring items, capitalized research and development, the present value of operating leases, and contingent liabilities.

EVA — Measure of operating results, calculated as net operating income minus capital charge.

Fixed assets — Property, plant, and equipment, minus accumulated depreciation, and plus leasehold improvements and reserves for write-downs.

Indexed — Adjusted according to a base period, with all figures expressed in the same terms (e.g., in 1997 dollars).

Inflation — Increase in the volume of money and credit relative to available goods and services, resulting in a rise in prices. On expense, inflation is a cost increase. On revenue, inflation is a price increase. EVA uses the CPI-U inflation percentage.

Net operating income (NOI) — Total income from operations.

Net working capital — Investments of cash, accounts receivable, and inventories, minus short-term liabilities such as payrolls and amounts owed to vendors.

Nominal — Represents current-year or actual Postal Service Financial Report (PSFR) dollars.

Operating expenses — Expenses in the Postal System Financial Report (PSFR) plus or minus the total of all economic adjustments.

Other capital — Investments in capitalized research and development, other noncurrent assets, and deferred retirement assets minus deferred retirement liability.

Present value of operating leases — Computed as actual YTD PSFR line 41 times the present value factor (currently 2.5).

Rate change — Increase or decrease in postal prices.

2-2 Calculating EVA at the National Level

The elements of EVA are revenue, expenses, and capital. Indexed EVA calculations for FY 1996, FY 1997, and FY 1998 appear in Exhibit 2-2.1, followed by the formula for calculating indexed EVA. A typical national AP EVA report is shown in Exhibit 2-2.2.

Exhibit 2-2.1

National EVA History from FY 1996 through FY 1999

EVA History Analysis (in \$000)	1996 Actual	1997 Actual	1998 Actual	1999 Actual
At Net Income of:	\$ 1,567,180	\$ 1,264,000	\$ 550,243	\$ 363,411
PSFR Revenue	56,543,739	58,214,182	60,077,296	62,619,406
- Rate Change Adjustment			(74,079)	(1,255,706)
+ Inflation Adjustment			973,252	2,405,457
= Indexed Operating Revenue	56,543,739	58,214,182	60,976,469	63,769,157
- PSFR Expenses	54,976,559	57,099,170	59,566,391	62,285,543
+/- Economic and EVA Adjustment	779,201	1,075,155	513,215	543,967
= Net Operating Income	2,346,381	2,190,167	1,923,293	2,027,581
Average Capital	10,636,967	11,367,604	11,757,290	12,299,021
- Capital Charge	1,276,436	1,364,113	1,410,875	1,475,883
= Indexed EVA	1,069,945	826,054	512,418	551,698
Maximum Potential Incentives	367,486	346,514	288,105	297,925
EVA Accrual (Actual Earned after Audit)	252,398	302,065	277,049	253,953
Incentives Paid	168,265	185,200	178,776	167,062
Reserve	84,133	200,998	261,092	329,915
Paid as Terminal Incentives			38,179	18,068
Adjusted EVA	\$1,069,945	\$ 826,054	\$ 512,418	\$ 551,698
Difference Between Net Income & EVA	497,235	437,946	37,825	(188,287)
Formula: YTD Indexed EVA =				
+ Nominal (PSFR) Revenue				
- Revenue Adjustment				
= Indexed Operating Revenue				
- Expense Adjustment				
= Net Operating Income (NOI)				
- Capital Charge				

Exhibit 2-2.2
National AP3 Indexed EVA Report

United States Postal Service Economic Value Added (EVA) AP 3, 1999 \$ in 000's					
	AP 3 Actual	AP 3 SPLY	Variance \$	Variance %	1998 Audited YE
PSFR Lines 01 – 03, 06	\$ 14,289,605	\$ 13,971,543	\$ 318,062	2.3	58,545,560
PSFR Lines 04 – 05, 07	302,873	227,278	75,595	33.3	1,464,462
Appropriations	16,386	15,482	904	5.8	67,274
Total Operating Revenue	14,608,864	14,214,303	394,561	2.8	60,077,296
Plus Inflation Adjustment*	459,401	295,658			973,252
Less Rate Increases	(24,693)	(24,693)			(74,079)
Revenue Adjustment	434,708	270,965			899,173
Indexed Operating Revenue	15,043,572	14,485,268			60,976,469
Expenses	14,007,000	13,251,900			59,566,391
EVA Expenses per Detail	13,886,634	13,076,554	810,080	6.2	59,053,176
Nominal Net Operating Income	722,230	1,137,749	(415,519)	(36.5)	1,024,120
Indexed Net Operating Income	1,156,938	1,408,714			1,923,294
Total Capital	13,251,861	12,242,091	1,009,770	8.2	11,757,290
Year-to-Date Cost of Capital	2.8%	2.8%			12%
Capital Charge	366,975	339,012	27,963	8.2	1,410,875
YTD Nominal EVA	\$ 355,255	\$ 798,737	\$ (443,482)	(55.5)	\$ (386,754)
YTD Indexed EVA	\$ 789,964	\$ 1,069,702			\$ 512,419
*YTD Inflation Factor	3.2%	2.1%			
Earned Incentives					
PCES Incentive	19.2%				16.00%
EAS Incentive	9.6%				8.00%
EAS-Non-Exempt	4.8%				4.00%

* (Inflation adjustment is applied to revenues net of rate increase adjustment)

2-3 Calculating Index Operating Revenue at the National Level

The elements of indexed operating revenue are the National Consolidated Revenue and Expense Report (lines 1 to 7) plus appropriations, an inflation adjustment, and a rate change adjustment.

Formula: YTD Indexed Operating Revenue =

- + Revenue lines 01, 02, 03, 06
- + Revenue lines 04, 05, 07
- + Appropriations line 08
- = Nominal Operating Revenue
- Revenue Adjustment

Procedure: Calculating Indexed Operating Revenue

Nominal revenues are indexed by adding an adjustment for inflation and subtracting the impact of any rate change. To eliminate revenue generated from sources other than operations, the revenue impact of price increases is deducted from PFSR revenue.

Formula: Indexed Operating Revenue =

- + Nominal Revenue
- Postal Price Increase
- + Inflation Adjustment

Step 1: Calculate Nominal Operating Revenue

The EVA calculation starts with nominal revenue.

Using the National Consolidated Revenue and Expense Report, add revenue lines 1 to 7, plus appropriations, to determine nominal revenue.

Step 2: Calculate a Composite Percentage Increase in Postal Prices

In the formula below, 0.029 represents the rate case (R-97), 1.029 the percentage change in postal prices, and 0.75 the percentage of the AP when the new prices became effective.

Formula: Price Change Revenue Adjustment for FY 1998 AP EVA =

- [(FY 1999 AP 05 Nominal Revenue
- FY 1999 AP 04 Nominal Revenue
- × 0.029) / (1.029 * 0.75)
- + (Current FY AP Nominal Revenue
- AP 5 Nominal Revenue
- × 0.029) / (1.029)
- + (Cumulative adjustments from prior years)]

Until now, the price change has been applied to forecast in the national indexed EVA calculation.

Example: Rate Change in Base

Special Services' classification and fee increases, implemented in FY 1997, increased revenue in FY 1998. In total, the classification and fee changes recommended by the Commission increased Postal Service annual net revenues by \$107 million. The implementation date was June 8, 1997, or AP10 of FY 1997.

The \$107 million represented 0.2 percent of Postal Service revenue: 0.05 percent in FY 1997 and 0.15 percent in FY 1998.

The adjustment methodology works as follows: in APs 10 to 13 of FY 1997, revenue increased due to higher rates and fees in the base. Thus starting in AP 1 of FY 1998, 1/13 of the revenue impact, or \$8.231 million, was subtracted from each AP's total revenue through AP 9, FY 1998 to remove the rate effect. The impact on 1998 and subsequent years is negative \$74.079 million. (See Exhibits 2-3.1 and 2-3.2.)

Exhibit 2-3.1

EVA Price Adjustment by AP by Fiscal Year (\$ Thousands)
(To conserve space, not all accounting periods are shown.)

	AP 1	AP 2	AP 3	AP 4	AP 5	AP 6	AP 7	AP13	YE 14
FY 1997								8.231	
Total FY 1997								33	
FY 1998	8	8	8	8	8	8	8		-
Total FY 1998	8	16	25	33	41	49	58	74	
Prior Year Cumulative	8,231	16,462	24,693	32,924	41,155	49,386	57,617	74,079	74,079
FY 1999 YTD	-	-	-	-	109,109	245,137	383,892	1,170,444	1,181,749
Total FY 1999	8,231	16,462	24,693	32,924	150,264	294,523	441,509	1,244,523	1,255,828
Prior Year Cumulative	8,231	16,462	24,693	32,924	150,264	294,523	441,509	1,244,523	1,255,828
FY 2000 YTD	144,807	292,792	438,361	583,833	693,067	693,067	693,067	693,067	693,067
Total FY 2000	(153,038)	(309,524)	(463,054)	(616,757)	(843,331)	(987,590)	(1,134,576)	(1,937,591)	(1,948,895)
Prior Year Cumulative	(8,231)	(16,462)	(24,693)	(32,924)	(150,264)	(294,523)	(441,509)	(1,244,523)	(1,255,828)
FY 2001 YTD									
Total FY 2001									

Exhibit 2-3.2
Rate Change Adjustment Methodology

The EVA indexing revenue for postal rate increases is equal to revenues received after prices are increased minus the revenues that would have been received had prices not changed. It can be expressed mathematically as:

Price Change Revenue Adjustment =

$$\frac{0.29 * \text{Revenues}_{\text{New Rates}}}{1.029}$$

This is the formula that will be applied to all revenues received after the rate change is implemented.

Step 3: Calculate the Inflation Adjustment

The inflation adjustment is determined by obtaining the current AP Consumer Price Index for all urban consumers (CPI-U) and calculating the percentage change to the base. This percentage is rounded to 4 positions.

The final adjustment to the FY 1998 inflation factor represents the period from August 31, 1997 through August 31, 1998. A preliminary inflation factor is pulled from the DRI forecast database monthly (tracking the rate of inflation) to be used in the national EVA calculation performed each accounting period. The final inflation factor is the change from the base period (FY 1997) to the current CPI-U. The CPI-U can be found on the Web at <http://stats.bls.gov/news.release/cpi.news.htm>. In the national EVA calculation, the rate adjustment is removed from total operating revenue, then multiplied by the inflation factor. The result is the inflation adjustment portion of indexed operating revenue.

In Exhibit 2-3.3, there are thirteen accounting periods within a twelve-month year. Thus AP 12 and AP 13 fall within the same calendar month for calculating the inflation factor.

Steps to calculate an adjustment for inflation:

- 1> Subtract the rate increase from the nominal operating revenue.
- 2> Multiply that result by the year-to-date inflation factor for the appropriate AP.

Exhibit 2-3.3
AP Inflation Adjustment

FY	Date	Index CPIU	Inflation Factors	AP	Inflation Dollars
1997	8/31/96	1.573	2.88%	ap1	
	9/30/96	1.578	3.00%	ap2	
	10/31/96	1.583	2.99%	ap3	
	11/30/96	1.586	3.26%	ap4	
	12/31/96	1.586	3.32%	ap5	
	1/31/97	1.591	3.04%	ap6	
	2/28/97	1.596	3.03%	ap7	
	3/31/97	1.600	2.76%	ap8	
	4/30/97	1.602	2.50%	ap9	
	5/31/97	1.601	2.23%	ap10	
	6/30/97	1.603	2.30%	ap11	
	7/31/97	1.605	2.23%	ap12	
	7/31/97	1.605	2.23%	ap13	
1998	8/31/97	1.608	2.23%	ap1	\$ 105,494
	9/30/97	1.612	2.15%	ap2	203,897
	10/31/97	1.616	2.08%	ap3	295,658
	11/30/97	1.615	1.83%	ap4	344,825
	12/31/97	1.613	1.70%	ap5	402,380
	1/31/98	1.616	1.57%	ap6	443,916
	2/28/98	1.619	1.44%	ap7	475,241
	3/31/98	1.620	1.23%	ap8	516,833
	4/30/98	1.628	1.60%	ap9	609,523
	5/31/98	1.628	1.67%	ap10	787,672
	6/30/98	1.628	1.54%	ap11	855,529
	7/31/98	1.635	1.87%	ap12	928,480
	8/31/98	1.635	1.68%	ap13	969,484
	8/31/98	1.635	1.68%	YE	974,582
	9/30/98	1.643	4.10%	ap1	108,525
	10/31/98	1.643	3.77%	ap2	211,824

Step 4: Calculate Revenue Adjustment

Formula: Revenue Adjustment =

- Price Increases
- + Inflation Adjustment

Subtract the price change from the inflation adjustment.

Step 5: Calculate Index Operating Revenue

Formula: Indexed Operating Revenue =

- Nominal Operating Revenue
- +/-Revenue Adjustment

Sum nominal operating revenue to the revenue adjustment (positive or negative) to get the index operating revenue.

2-4 Calculating Indexed Net Operating Income at the National Level

Formula: Indexed NOI =

Indexed Operating Revenue

– EVA Expenses

PSFR expenses, including lines 10 through 5H plus or minus the economic adjustments as highlighted in Exhibit 2-4.1, equal EVA expenses. EVA expenses are subtracted from indexed operating revenue to calculate indexed net operating revenue at the national level.

Economic adjustments made to the NOI are reported in the Postal Service financial reports. These adjustments eliminate the impact of financing and investing, accruals that do not reflect current-year performance, and some expenses that are capitalized. At the national level, the adjustments are made as shown in Exhibit 2-4.1:

Exhibit 2-4.1

Adjustments to Net Operating Income

+/- Economic Adjustments to Net Operating Income	Reason for the Adjustment
Subtotal Additions:	
Increase in Bad Debt Allowance	Noncash Accrual
Research & Development Expense	Capitalized
Imputed Interest Expense — Operating Leases	Nonoperating Cost
Non-cash Workers' Compensation Expenses	Noncash Accrual
Interest Expense on Debt	Nonoperating Item
Retroactive COBRA Expense	Unusual Charge
Contingent Liability Accrual	Nonoperating/Unusual
Extraordinary (Non-Operating and Unusual) Adjustments Involving Restructuring and/or Debt Refinancing Costs	Reason for the Adjustment
Inspector General	Legal mandate not in FY 1997 base
Subtotal Additions:	
Subtract:	
Interest Income	Nonoperating Item
Amortized R&D	Write Off of Capital Expense
Extraordinary	Nonoperating/Unusual
Subtotal Subtractions:	
= Net Operating Income (Loss)	

Note: Adjustments listed above are not all-inclusive and reflect unusual charges that are infrequent and/or intermittent and that may recur in the future.

Exhibit 2-4.2 gives a historical perspective of the magnitude of adjustments against net operating income.

Exhibit 2-4.2

Major Economic Adjustments from Net Income

(\$ Thousands)	1996 Actual	1997 Actual	1998 Actual	1999 Actual
Workers' Comp Economic Adjustment	\$ 213,914	\$ (331,297)	\$ 201,666	\$ 18,332
Interest on Debt	396,540	328,738	210,577	216,594
Interest on Operating Leases	163,570	171,164	182,769	196,427
POD WC Chargeback		240,000	8,200	11,100
Increase in Bad Debt Allowance	(4,991)	3,292	22,918	13,211
Amortized R&D	(76,652)	(56,594)	(60,521)	(63,732)
Research & Development	55,466	67,138	77,137	67,021
Contingent Liability Accrual Inc	79,900	14,402	(88,016)	136,900
EVA Accrual Adjustment	(4,000)	0	0	0
OBRA	47,300	32,300	16,700	0
IG Exp & Other Congressional Mandates		23,542	20,219	38,558
Total	\$ 1,071,047	\$ 823,982	\$ 591,649	\$ 634,411

2-5 Calculating Average Capital at the National Level

Formula: YTD Average Capital =

- + Weighted Average Fixed Assets
- + PV of Operating Leases
- + Average Working Capital and Other Capital

Each capital category is an average of AP data, and each is calculated differently. The average fixed asset balance is determined using a weighted technique. The present value (PV) of operating leases uses a net present value of a future minimum, lease-payment percentage factor. The entry "Average Working Capital and Other Capital" uses a simple averaging. Below is the averaging formula and an illustration for each major capital category.

Procedure: Calculating Capital at the National Level

To ensure that the capital charge reflects use, the average fixed asset balance is determined using a technique of weighted average capital. Exhibit 2-5.1 below illustrates the range of weighting, from full use at 13 to minimum use at 0.5.

Step 1: Calculate Weighted Average Fixed Assets

Formula: Weighted Average Fixed Assets =

EVA Fixed Assets

× AP Weighting Factor

= AP Weighted Fixed Assets

Sum-To-Date Weighted Fixed Assets

+ AP-To-Date's Total Weighting Factor

- 1> Multiply the EVA fixed assets across an AP by the associated AP weighted factor.
- 2> Sum AP weighted fixed assets to date.
- 3> Divide the result by associated AP-to-date's total of weighting factors.

In Exhibit 2-5.1, AP 1 has a total weighting factor of 25.5; AP 13 has a total weighting factor of 97.5. The formula starts with the previous year-end total and ends with AP 13 of the present year.

Exhibit 2-5.1

AP Weighting Factors (YE 97 to FY 98 AP13 Weighting From 13.0 to 0.5)

	1997 Year End	AP 1	AP 2	AP 3	AP 12	AP 13
EVA fixed assets	\$17,535,091	\$17,653,244	\$17,711,244	\$17,784,244	\$18,525,244	\$18,785,244
	AP weighting factors	AP weighting factors	AP weighting factors	AP weighting factors	AP weighting factors	AP weighting factors
AP 13	13	13	13	13	13	13
AP 1	12.5	12.5	12.5	12.5	12.5	12.5
AP 2	11.5		11.5	11.5	11.5	11.5
AP 3	10.5			10.5	10.5	10.5
AP 4	9.5				9.5	9.5
AP 5	8.5				8.5	8.5
AP 6	7.5				7.5	7.5
AP 7	6.5				6.5	6.5
AP 8	5.5				5.5	5.5
AP 9	4.5				4.5	4.5
AP 10	3.5				3.5	3.5
AP 11	2.5				2.5	2.5
AP 12	1.5				1.5	1.5
AP 13	0.5					0.5
Total Weighting Factor	97.5	25.5	37.0	47.5	97.0	97.5
Weighted Average Fixed Assets	\$17,746,731	\$17,593,009	\$17,629,758	\$17,663,907	\$17,741,378	\$17,746,731

Step 2: Calculate Present Value of Operating Leases

Formula: Present Value of Operating Leases =

AP PSFR line 41

x 2.5

x 13/AP

- 1> Multiply by 2.5 the rent expenses in PSFR line 41 for the associated AP.
- 2> Multiply this sum by the prorated AP.

Exhibit 2-5.2 shows the Stern Stewart EVA Methodology for Capitalizing Operating Leases. Exhibit 2-5.3 shows the AP PV of Operating Leases using the 1998 PV of Operating Leases as an example.

Exhibit 2-5.4 shows a historical perspective of weighted average fixed assets and the present value of operating leases.

Exhibit 2-5.2

**EVA Methodology for Capitalizing Operating Leases
1996 to Present — Stern Stewart EVA Model**

The Stern Stewart EVA model treats all "assets" the same, regardless of accounting treatment. Therefore, the EVA system treats all leases as capital leases for EVA purposes. This puts leased assets on the same plane as capital assets. The way to do this is to capitalize the net present value (NPV) of the future lease payments committed to by each performance cluster. Also, because EVA is a measure of operating results, expenses are reduced by the implicit interest expense present in operating leases. The Postal Service capitalizes operating leases by multiplying rent expense by a factor of 2.5. Expenses are reduced by assuming a 10 percent interest rate on the net present value of operating leases.

Digressing into accounting rules: depending on certain characteristics of the lease agreement, a lease may be accounted for as either "operating" or "capital." There are four criteria for determining if a lease is a capital lease; if the agreement meets any one of the criteria, it is accounted for as a capital lease. This means that it is put on the balance sheet as an asset, and an offsetting liability for the NPV of the future lease payments is recorded as well. Each payment that is made is then treated just like a mortgage payment, with a portion paying off the "principal" of the liability and the remainder being interest expense. The Postal Service does record capital leases but at the national level only. All field accounting treats all leases like operating leases in the performance clusters. However, under the EVA model all leases should be capitalized.

Historical data concerning the NPV of future minimum lease payments comes from the Postal Service Annual Report and is national data. The annual national rent expense numbers were compared to the NPV of lease commitment numbers from the annual report to see if there was a relationship. To summarize, over the decade or so that was analyzed, the NPV of future minimum lease payments was about 250 percent of the annual rent expense, which is the basis for the 2.5 factor.

The 2.5 factor does not address the appropriate life to be assigned to the leased asset. One of the capital lease criteria is that the lease term is greater than 75 percent of the expected useful life of the asset; this is one of the most often met criteria. There is an inherent assumption that this criterion is met in the way operating leases are capitalized. However, if the average remaining life of the leases is shorter than the average remaining lives of the underlying assets, then the EVA capital leases are understated, and so is the corresponding capital charge. This issue was addressed through the selection of the interest rate associated with operating leases.

A 10 percent interest rate was selected. Following the Stern Stewart model, it is necessary to reduce rent expense for the portion of the payment that represents interest. The implied interest rate in most leases is much higher than general interest rates. Prior to implementing EVA in the Postal Service, the rates in the private sector were around 16 to 20 percent. So, theoretically, rent expense should be reduced by this same amount. The reason 10 percent was chosen instead is because 1) there is no direct knowledge of what the implicit interest rates on Postal Service operating leases is, and 2) it was thought, as described above, that the assets (operating leases) were already undercapitalizing the assets.

Exhibit 2-5.3

AP PV of Operating Leases

1998 PV of Operating Leases (\$ in Thousands)					
	1997 Year End	AP 1	AP 3	AP 5	AP 7
PV of Operating Leases	1,711,643	1,832,903	1,864,558	1,558,843	1,661,823

Exhibit 2-5.4

Fixed Assets and PV of Operating Leases from FY 1996 Through FY1998

FY 1996 Through 1998 Fixed Assets \$ in Thousands	YE FY 1996	YE FY 1997	YE FY 1998
Ending Balance P,P&E			
Buildings	\$12,923,247	\$13,649,634	\$15,129,208
Equipment	9,716,911	10,235,946	11,145,870
Land	2,106,964	2,177,913	2,286,072
	<u>\$24,747,122</u>	<u>\$26,063,493</u>	<u>\$28,561,150</u>
Accumulated depreciation	(8,843,225)	(9,342,789)	(10,362,257)
	<u>\$15,903,897</u>	<u>\$16,720,704</u>	<u>\$18,198,893</u>
Leasehold improvements	380,965	437,723	490,813
Total in service	<u>\$16,284,862</u>	<u>\$17,158,427</u>	<u>\$18,689,706</u>
 Add back allowances:			
Reserve for write-downs — acct # 17203	23,244	23,244	23,244
 EVA fixed assets	<u>\$16,308,106</u>	<u>\$17,181,671</u>	<u>\$18,712,950</u>
Weighted average fixed assets	<u>\$15,672,411</u>	<u>\$16,740,604</u>	<u>\$17,853,131</u>
 PV of Operating Leases	<u>\$1,635,698</u>	<u>\$1,711,643</u>	<u>\$1,827,693</u>

Step 3: Calculate Average Working Capital and Other Capital

Formula: Average Working Capital and Other Capital =

- + YE AP 13
- + AP-to-Date
- + Count YE AP 13 to AP-to-Date

A simple average is used for working capital and other capital. Simple averaging includes the previous year-end total (see Exhibit 2-5.5).

- 1> Sum individual previous year AP 13 to APs-to-date.
- 2> Divide this total by the number of APs in the sum.

Exhibit 2-5.5

AP Average Working Capital and Other Capital (not consecutive APs)**1998 Average Capital \$ in Thousands**

	1997 Year End	AP 1	AP 3	AP 5
Total Working Capital & Other Capital	(6,326,212)	(7,557,108)	(7,221,383)	(7,398,135)
Average Working Capital & Other Capital	(7,180,113)	(6,941,660)	(7,286,715)	(7,341,503)

Exhibits 2-5.6a and 2-5.6b below illustrate EVA net working capital assets for FY 1996 through FY 1998. Historically, cash has been 1 percent of operating revenue. From FY 1999 forward, cash is total cash as reported in the Auditor Balance Sheet for the accounting period.

Working capital resources tied up in the business represent investments that could be used elsewhere for a higher rate of return. Therefore, a capital cost is assessed.

Exhibit 2-5.6a

Net Working Assets from FY 1996 through FY 1998 \$ in Thousands

Working Capital	YE FY 1996	YE FY 1997	YE FY 1998
Operating Revenue	\$56,436,569	\$58,204,082	\$60,139,296
Operating Cash	564,366	582,041	601,393
Gross Receivables	1,163,488	730,707	880,642
Supplies Advances & Prepayments	413,882	432,734	340,803
Compensation & Benefits Payable per Financial Statements	(5,594,546)	(5,744,630)	(6,201,807)
Adjustments			
Current OBRA liability – accts 22260, 22261, 22262	482,536	330,836	536
MSPB liability accrual – acct 22256	67,065	29,318	9,022
OWCP health benefits pre-86 accrual – acct 22259	2,901	1,249	2,119
Current Workers' Compensation Liability – acct 22311	525,061	600,986	595,850
Compensation & Benefits – EVA capital	(4,516,983)	(4,782,241)	(5,594,280)
PIHOP	(1,747,400)	(1,743,400)	(1,672,900)
Accounts Payable per Financial Statements	(1,915,278)	(940,101)	(1,307,838)
Adjustments			
Current Contingencies			
Accrued Interest Payable on Debt (acct 23407)	71,139	63,483	38,443
Accounts Payable for EVA	(1,844,139)	(876,618)	(1,269,395)
Prepaid Permit Mail & Box Rentals	(1,390,992)	(1,462,994)	(1,547,179)
Outstanding Money Orders	(518,635)	(1,015,993)	(1,034,154)
Net Working Capital	(7,876,413)	(8,135,764)	(9,295,070)

Exhibit 2-5.6b

Other Assets From FY 1996 through FY 1998 (\$ Thousands)

Other EVA Capital	YE FY 1996	YE FY 1997	YE FY 1998
Capitalized R&D	\$ 107,170	\$ 112,898	\$ 126,478
Other (noncurrent) Assets	1,610	372,423	381,566
Deferred Retirement Asset	31,944,324	31,929,127	31,648,489
Deferred Retirement Liability	(30,622,446)	(30,342,965)	(29,793,321)
 Total Working Capital & Other Capital	 \$(6,445,755)	 \$(6,064,281)	 \$(6,931,858)
 Average Working Capital & Other Capital	 \$(6,924,471)	 \$(7,152,915)	 \$(7,902,222)
 Actual Average Capital	 \$10,383,638	 \$11,299,331	 \$11,778,602

Step 4: Final Summation of Average Capital**Formula: Average Capital =**

- + Average Weighted Fixed Assets
- + PV of Operating Leases
- + Average Working Capital and Other Capital

Finally, sum the three averaging techniques to determine the net actual average capital that is used to compute the capital charge (see Exhibit 2-5.7).

Exhibit 2-5.7

AP Summation of Average Capital

1998 Average Capital \$ In Thousands								
	1997 Year End	AP 1	AP 2	AP 3	AP 4	AP 5	AP 6	AP 7
Weighted Average Fixed Assets	17,746,731	17,593,009	17,629,758	17,663,907	17,515,297	17,565,252	17,602,751	17,641,219
PV of Operating Leases	175	27	51	72	93	110	125	138
Average Working Capital & Other Capital	(7,180,113)	(6,941,660)	(7,308,493)	(7,286,715)	(7,330,177)	(7,341,503)	(7,334,058)	(7,381,509)
Actual Average Capital	10,566,793	10,651,376	10,321,316	10,377,265	10,185,213	10,223,859	10,268,818	10,259,848

2-6 Calculating Capital Charge at the National Level

Procedure: Calculating Capital Charge**Formula: Capital Charge =**

$$\text{Average Capital} \times \text{Cost of Capital}$$

The capital charge is the actual average capital multiplied by the prorated AP cost of capital (see Exhibit 2-5.7 for average capital).

Step: Prorate Capital Charge to the AP

Multiply the net average capital by the cost of the capital charge prorated to the AP. (See Exhibit 2-6.)

Formula: Capital Charge Prorated to the AP =

- + Average Capital
- × 12 percent / 13
- × Current AP

**Exhibit 2-6
AP Capital Charge**

1998 Capital Charge \$ in Thousands					
	1997 Year End	AP 1	AP 3	AP 5	AP 7
Actual Average Capital	\$12,278,261	12,484,251	12,241,750	11,782,591	11,921,532
Capital Charge	\$	115,239	339,002	543,812	770,314

Recap: Net operating income minus the capital charge equals EVA, which funds the variable pay program and the incentive payout for employees.

2-7 Calculating the Incentive Payout

Procedure: Calculating the Incentive Credit and Payout

Indexed EVA funds the Variable Pay Program. Funding is 65 percent of EVA up to the first \$400 million (positive or negative), and 25 percent of EVA over \$400 million (positive or negative). (See Exhibit 2-7.1.)

Step 1: Calculate Funding

The first \$400 million of indexed EVA is multiplied by 65 percent. Anything over \$400 million is multiplied by 25 percent.

**Exhibit 2-7.1
Incentive Funding Calculation (\$ Millions)**

Net Income	Actual	\$800 Fund
EVA	\$ 768	
Fund ≤ \$400 * 65%	400	\$ 260
Fund > \$400 * 25%	368	92
Total potential earned		352

Step 2: Calculate the Employee Universe

Each fiscal year, Employee Resource Management provides Finance with the employee universe, or the number of employees in each employment category and the average salary per employee category. This employee universe is used in calculating the credit and payout percentages of the Variable Pay Program. (See Exhibit 2-7.2.)

- 1> Calculate total payroll: multiply the number of employees by the average salary.
- 2> Calculate the weighted payroll using the weighting factors, as fixed by the Board of Governors.

Exhibit 2-7.2

Employee Universe (\$ Whole)

	Number of Employees	Total Payroll	Weighting Factors	Weighted Payroll
PCES II	41	\$ 5,734,055	4	\$ 22,936,220
PCES I	916	90,018,068	3	270,054,204
EAS — Regular	27,595	1,417,224,010	1.5	2,125,836,015
EAS — Converted Exempt	33,596	1,828,139,368	1.5	2,742,209,052
Total EAS Exempt	63,191	3,245,363,378		4,868,045,067
EAS — Non-exempt	<u>17,694</u>	<u>721,968,282</u>	0.75	<u>541,476,212</u>
Total	81,842	\$ 4,063,083,783		\$ 5,702,511,703

The following steps result in the EVA payout percentage to employees by category.

Step 3: Calculate Incentive Credit and Payout Using EAS Regular Category

- 1> Divide the employee category weighted payroll by the total weighted payroll to get the incentive sharing ratio.

Formula: Incentive Sharing Ratio =

Weighted Payroll (2,125,836,015) / Total Weighted Payroll
(5,702,511,703) = 0.372789

- 2> Multiply the sharing ratio by the incentive funding to get potential incentive credit.

Formula: Total Potential Incentive Credit =

Incentive Sharing Ratio (0.372789) * Total Potential Credit
(352,000,000) = \$131,221,875

- 3> Divide that result by the employee category total payroll.

Formula: Incentive Credit Percentage =

Potential Incentive Credit (\$131,221,875) / Total Payroll
(\$1,417,224,010) rounded to 3 places = 9.30 percent

- 4> Multiply the incentive credit percentage by payout percentage to get the incentive paid percentage.

Formula: Incentive Paid Percentage =

Incentive Credit Percentage (0.093) * Payout Percentage (0.333)
rounded to 3 places = 3.10 percent

The beginning average percentage in the reserve account is updated in AP 4 after the EVA closeout (see Exhibit 2-7.3). The beginning (SPLY) average percentage payout in this formula is 7.40 percent.

Add the incentive credit to SPLY incentive payout and multiply by the payout percentage to get with reserve account payout incentive.

$$\text{Formula: With Reserve Account Percentage Payroll Payout} = \text{ROUND}((9.30 + 7.40) * (0.33), 3) = 5.50 \text{ percent}$$

Exhibit 2-7.3

Incentive Earned and Payout Percentage

Incentive Calculations:					
	Current YTD Actual		Reserve Account	With Reserve Account	
	YTD Actual Rounded % Credit	YTD Actual Rounded % Payout	Year-End Rounded % Begin Average %	YTD Actual Rounded % Payroll Payout	SPLY Rounded % Payroll Payout
PCES II	24.70%	8.00%	12.6%	12.00%	15.00%
PCES I	18.50%	6.10%	14.6%	10.90%	15.10%
EAS Regular	9.30%	3.10%	7.3%	5.50%	7.40%
EAS-Converted Exempt	9.30%	3.10%	7.3%	5.50%	7.40%
EAS – Non-Exempt	4.60%	1.50%	2.2%	1.50%	2.60%

Recap:

Potential incentive credit for PCES, EAS, and EAS Nonexempt is reflected in the national EVA report on the Finance home page on the corporate intranet (<http://blue.usps.gov/finance>), and under corporate database in Option 15. For PCES II, the potential percentage credit is subject to the maximum salary cap for PCES executives.

For FY 1999, the payout percentage is the percentage credit times 33 percent. The YTD actual percentage payout adds the reserve account beginning average percentage to the potential percentage credit and multiplies the sum by 33 percent.

Exhibit 2-7.4 shows a history of average incentives and payouts since the EVA program began.

Exhibit 2-7.4

Average Credit and Payout Percentages

1996 Results	EAS Nonexempt	EAS Exempt	PCES Executive
Maximum Reward on \$1,070M EVA	6.50%	13.00%	26.00%
Average Earned	5.20%	10.50%	21.00%
Average Payout	5.20%	7.03%	14.09%
1997 Results	EAS Nonexempt	EAS Exempt	PCES Executive
Maximum Reward on \$826M EVA		10.50%	21.00%
Average Earned	5.60%	9.40%	19.20%
Average Payout	5.60%	6.50%	13.10%
1998 Results	EAS Nonexempt	EAS Exempt	PCES Executive
Maximum Reward on \$512M EVA	4.00%	8.00%	16.00%
Average Earned	3.60%	7.50%	14.40%
Average Payout	1.50%	5.20%	10.50%
1999 Results	EAS Nonexempt	EAS Exempt	PCES Executive
Maximum Reward on \$552M EVA	3.80%	7.50%	15.00%
Average Earned	3.20%	6.60%	12.30%
Average Payout	1.80%	4.60%	8.90%

Note: Once the national percentage credit is calculated, the amount credited to employees' reserve accounts or payout is based on how well their organizational units have achieved performance targets (see Exhibit 1-4.2, *CustomerPerfect! Goals*).

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.



Scott L. Reiter

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September 12, 2000